This record is a partial extract of the original cable. The full text of the original cable is not available.

UNCLAS SECTION 01 OF 04 FRANKFURT 000174

SIPDIS

SENSITIVE

STATE FOR EUR PDAS, EB, EUR/AGS, AND EUR/ERA
STATE PASS FEDERAL RESERVE BOARD
STATE PASS NSC
TREASURY ALSO FOR ICN COX, HULL

E.O. 12958: N/A
TAGS: ECON EFIN EUN
SUBJECT: EU's Stability and Growth Pact: Tidying Up the Books - the Corrective Tonic of Transparency

This cable is sensitive but unclassified. Not/not for Internet distribution.

¶1. (SBU) Summary: In December the European Commission (EC) issued several statements for member states under the Stability and Growth Pact's (SGP) excessive deficit procedures (EDP). For Germany and France, the Commission acknowledged that (a) both would get an extra year, to 2005, to correct their deficits and (b) their proposed 2005 budgets might barely do the trick, thanks to one-off measures. For Greece, the EC, weaving through the haze of statistical corrections and mid-year budget adjustments, declared the draft 2005 budget "insufficient" to correct the deficit. Similarly Hungary was cited by the EC as having taken "insufficient action" to put the 2005 budget on a trajectory to get the deficit below 3 percent by 2008. The Czech Republic, Cyprus, Malta, Poland, and Slovakia were judged by the EC as having put forward 2005 budgets that are in line with their respective convergence programs. The Council will have to decide what steps to take on Greece and Hungary, a difference being that Hungary is not subject to the SGP sanctions provisions since it has not yet adopted the euro.

¶2. (SBU) The EC's published reports and willingness to challenge budget proposals of member states are important for the SGP's "soft law" to be effective. A recent European Central Bank (ECB) paper suggests that the member state "contracting parties" to the SGP will never act as collectively through ECOFIN as an independent enforcement agency. Rather, they are likely to be pressured into avoiding big mistakes by the public scrutiny through transparency. The corrective tonic of transparency is, in this case, being administered by the Commission. End Summary

-- -----
Tidying Up the Books: Year End Commission Reports
-- -----

¶3. (SBU) In December the EC published conclusions on the 2005 budgets for member states subject to EPD. These reports set the stage for ECOFIN's meetings in January and February. Two countries are likely to require further action by the Council: Greece and Hungary. A summary of the actions follows.

¶4. (SBU) Greece: In July ECOFIN recommended that the deficit be reduced to 3 percent in 2005. That was before statistical revisions due to under-recorded expenditures on military equipment and interest expenditures and over-estimations on social security. While these pushed up the 2004 deficit from 3.0 to 4.1 % of GDP, in September the Greek authorities reported that the deficit would be 5.3%. While the Greek official 2005 budget shows a 2.8% deficit, the Commission's analysis suggests this is overly optimistic on both the revenue and expenditure accounts. Thus, the EC reckons a deficit of 3.6% and is of the opinion that "there has been no effective action" in response to the Council's recommendation. The Commission recommends the Council agree.

¶5. (SBU) Hungary: In July ECOFIN recommended that the deficit should be reduced in line with the Hungarian convergence program. Specifically, that means that the deficit is to be under 3% of GDP by 2008, and that the Hungarian authorities are to "introduce additional measures, if necessary," to hit the 2004 budget target of 4.6%. Despite several corrective measures taken by the Hungarian authorities in 2004, the deficit officially is estimated to be 5.3% of GDP while Commission staff estimate it to be 5.5%. (Preliminary December revenue data suggest that the deficit may hit the government's projection). The government's budget for 2005 has a deficit of 4.7%, but the Commission also waves this off as too optimistic, forecasting a deficit of 5.2%. The EC is also critical that structural reforms contained in Hungary's convergence

program were not fully reflected in the 2005 budget, thus failing to put into place measures that would restrain expenditures over the longer term. In conclusion, the Commission believes that the action by Hungarian authorities has been "inadequate," and is of the opinion that "there has been no effective action" in response to ECOFIN's recommendations. It recommends that the Council agree.

¶6. (SBU) Germany and France: ECOFIN recommendations date from 2003, January for Germany and June for France. Both called for the excessive deficits to be corrected in 2004. The Council's conclusions in November 2003 to give both Germany and France an extra year were annulled by the European Court of Justice in July 2004 on procedural grounds. Nonetheless, the Commission reasons that both countries had the "right to assume" that the Council conclusions were valid and, accordingly, had set a path for adjustment in 2005 that "cannot be ignored." "In light of the unique circumstances created by the Court judgment" the Commission concedes that 2005 should be the target year for correcting the deficit.

¶7. (SBU) The German budget for 2005 aspires to a 2.9% deficit. To get there, the government relies on several one-off measures. These include securitization of pension receipts of an off-budget pension fund from the privatized Deutsche Post and Telekom (to the tune of euro 5.45 billion or 0.25% of GDP) and the repayment of illegal subsidies by state banks to state governments (euro 4.3 billion, around 0.2% of GDP). While the Commission is critical of such one-off measures, its own calculations suggest the budget deficit should drop to 3%, but remains "vulnerable" should programs or economic growth not materialize as forecast. Its conclusion is that the actions by German authorities are "broadly consistent" with a correction of the excessive deficit by 2005 and that "no further steps are necessary" at this point.

¶8. (SBU) The French budget projects a deficit of just under 3% for 2005, an estimate with which the Commission roughly agrees. Deficit reductions are based on one-off measures, particularly a payment linked to the transfer of the responsibility for pensions in the electricity and gas companies to the social security sector (about 0.5% of GDP). Thus, the deficit projection is "vulnerable" to changes in program implementation and economic growth. Moreover, based on an assumption of no policy changes, EC staff forecasts the deficit to bounce back up to 3.3% in 2006 in sharp contrast to the French government projection of 2.2%. In conclusion, the Commission believes that actions by the French authorities are "broadly consistent" with a correction of the excessive deficit by 2005 and that "no further steps are necessary," at this point.

¶9. (SBU) Czech Republic, Cyprus, Malta, Poland, and Slovakia: In July ECOFIN recommended that these countries take the necessary steps in 2004 and 2005 to put them on the path of their convergence programs designed to correct the excessive deficits. The Czech Republic has taken effective action to achieve the 2005 target of 4.7% on the way to get under 3% by 2008. Cyprus has taken action to bring its 2005 budget under 3%. Malta has taken effective action, although somewhat belatedly, to hit its budget deficit target of 3.7% in 2005 and to get it under 3% in 2006. Poland has taken effective action to achieve a deficit of 4.2% in 2005 on the way to correct its excessive deficit by 2007. Slovakia also has taken effective action to achieve a 3.9% deficit in 2005 consistent with its objective of reducing the deficit below 3% by 2007. In all cases, the Commission concludes, "no further steps are necessary at this point."

-- -----------
Next Steps: Greece and Hungary in the Dock; Germany and France on the Hook
-- -----------

¶10. (SBU) ECOFIN will have to decide whether it agrees with the Commission's recommendations on Greece and Hungary. In both cases, the basic approach would be to revise the Council's earlier recommendations with alternative, extra measures. For Hungary this would mean a revised convergence program, taking account of the Commission's assessment. Since Hungary has not yet adopted the euro, it is not subject to provisions on intensive surveillance and sanctions (paragraphs 104(9) and 104(11) of the Treaty, respectively).

¶11. (SBU) For Greece the issues are likely to be more complex. A special Eurostat report for 1997-2003 reveals that the deficit has been revised up by an average of 2.1% of GDP and was never under the 3% of GDP reference value. On December 1 the Commission launched an infringement proceeding to ensure Greek authorities address "a number of problems in its reporting and control of deficit-related data." This proceeding carries no sanctions but, according to Commission staff, applies public pressure on the Greek

authorities. ECOFIN's own take at its December session was that there was blame to be shared by all: Greek authorities, Eurostat, the Commission and ECB and the Council itself for not paying sufficient attention to the quality of the data.

¶12. (SBU) Even if the implications of Greece statistical problems could be put aside, if ECOFIN agrees with the Commission's recommendation that insufficient steps have been taken to correct the deficit, then ECOFIN will have to decide on the next steps. Commission staff initially had suggested that Greece be subject to more intense surveillance under paragraph 104(9) of the Treaty, the last step before sanctions. This approach would be consistent with the ill-fated Commission recommendations for Germany and France in November 2003. However, this approach did not appear in the final Commission report. A German Finance Ministry official suspects that the Commission wants to ease ECOFIN along, first agreeing with the insufficient action recommendation, then spring the 104(9) recommendations on the Council. The Greeks then could take a page out of the German book and argue that when the Council made it policy recommendations in July 2004, the deficit was only 3.2% and that statistical revisions and other extraordinary developments (Olympic expenditures) require new recommendations under 104(7) rather than ratcheting up the procedures to the next level.

¶13. (SBU) For their part, the Germans would like the Council to think more about cutting off cohesion funds to Greece, which are around euro 550 million. In their view, Article 6 of Council Regulation (EC) No 1164/94 of 16 May 1994 is clear: "In the event of the Council deciding, in accordance with Article 104(6) of the Treaty, that an excessive government deficit exists in a Member State, and if that decision is not abrogated in accordance with Article 104(12) of the Treaty within one year or any other period specified for correcting the deficit in a recommendation under Article 104(7), no new projects or, in the case of large multi-stage projects, no new stages of a project shall be financed from the Fund for that Member State." The German Finance Ministry recalls that Greece's voted against the Council's conclusions to give Germany an extra year to correct its deficit. Germany is a net contributor to the EU budget (an expenditure that contributes to its excessive deficit), from which the Greek authorities benefit.

¶14. (SBU) Germany and France are being given a conditional pass, but also put on warning. If their efforts falter, for any reason, the Commission staff promise to restart the EDP under Treaty articles 104(9). This approach is just what the Council recommended in November 2003. The EC could initiate such proceedings any time, but are likely to wait until firm 2005 figures are confirmed in March 2006. Even if France squeaks by in 2005, EC staff believe that unless policies change, the deficit will pop back up in 2006, putting France back into an active EDP.

¶15. (SBU) Germany also faces risks. Eurostat has not yet officially ruled whether the securitization of pension receipts will reduce the deficit on a sustainable basis. If Germany is merely postponing a liability, the measure would not reduce the deficit, according to Eurostat rules. German Finance Ministry experts have engaged directly with Eurostat staff and are confident that, in economic terms their one-off measure is like France's. But with a difference.

¶16. (SBU) In France, Eurostat accounting rules mean that the transfer of the responsibility for payments of pensions of former state employees now working in the privatized electricity and gas companies to the social security system implies a lump sum revenue inflow for the general government in 2005. (Under Eurostat accounting conventions, the government can book all of the imputed pension payments that would have been made by those companies over the next twenty years as income as of the date of transfer of the obligation). Since the government had no liability to pay pensions in the privatized firms, it is not getting money now that it would have been obliged to repay later. However, as the EC points out, the transfer does imply additional expenditures in future years for the social security system since that system will assume responsibility for all of the future pension benefits of these employees. Although Eurostat has not formally certified the French transaction, the transaction is very similar to a Belgian telecom transaction that Eurostat has certified.

¶17. (SBU) In Germany the pension liabilities of civil servants working in the privatized Post and Telekom firms were not ceded with the new firms but rather placed in a separate "Post Pension Fund." The government supplements that fund from the budget, if necessary. Last year the government paid euro 5.5 billion into the Fund. However, Finance Ministry officials point out that the government has no standing liability to the Fund. Therefore, like the French, it is not postponing a liability but at the same time is admitting that the Post Pension Fund, like France's

social security system, in the future would bear the full cost of those civil servants' pensions that the government will have to supplement. Eurostat, according to German Finance Ministry officials, have reserved judgment until details of the transactions are finalized, probably by March.

Comments: Obfuscation and Transparency

¶18. (SBU) The Commission's recommendations set new benchmarks for fiscal discipline. For Greece and Hungary the outcomes will likely be new policy recommendations. Greece runs the risk of being escalated up to paragraph 104(9), one step before sanctions unless, like Portugal did, it convinces ministers' that its 2005 budget that pushes the deficit down from 5.3% of GDP to 2.8% is solid and/or that, in light of all the uncertainty surrounding its statistics, it should be given a new set of recommendations under the less-threatening paragraph 104(7).

¶19. (SBU) On Germany and France, the Commission engages in a bit of obfuscation. The issue in both cases was not whether the deficits should be corrected in 2004 or 2005. By November 2003 the Commission was painfully aware that the deficits would remain above 3% in 2004. Rather, the issue was one of process, whether both countries should be subject to more intense surveillance under 104(9), the last step before sanctions. By declaring the 2005 budgets credible, the EC takes a pass on this issue, but sets the hook for both countries to be caught in 104(9) processes should they fail.

¶20. (SBU) More broadly, the Commission's public assessment and criticism of the budgets sets in motion more public pressure on all the member states with excessive deficits. As a recent ECB occasional paper points out, such pressure is important in applying the "soft law" of the SGP that is administered by contracting parties themselves rather than an independent body. While the dynamics of such a mechanism conditioned by politics is less than precise, it is likely to curb any egregious cases. In fact, the ECB paper points to research that indicates that the recent 2001-2003 slowdown has witnessed less "extreme budgetary deteriorations" than in the early 1990's.

¶21. (SBU) The ECB's paper also argues that simple rules, like the 3% GDP reference value, are easier to monitor and more susceptible to applying public pressure than more complex rules. It would be comforting to think that ECOFIN Ministers share that view and that it motivated their ruling out any changes in the basic framework in the SGP as they prepare a Council Resolution for March. In any event, the Commission is doing its job by shining the light on budget problems and should let ECOFIN take the political decisions on the "art of the possible," in budget matters.

¶22. (U) This message coordinated with Embassies Berlin, Paris, Budapest and USEU Brussels.

¶23. (U) POC: James Wallar, Treasury Representative, e-mail wallarjg2@state.gov; tel. 49-(69)-7535-2431, fax 49-(69)-7535-2238

Bodde